

## Consolidated Financial Statements December 31, 2003 and 2002



April 2, 2004

## **Auditors' Report**

### **To the Shareholders of Terrenex Acquisition Corporation**

We have audited the consolidated balance sheets and statements of quoted and unquoted investments of **Terrenex Acquisition Corporation** as at December 31, 2003 and 2002 and the consolidated statements of operations and (deficit) retained earnings and changes in net assets for the years then ended. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the company as at December 31, 2003 and 2002, its results of operations and changes in net assets for the years then ended in accordance with Canadian generally accepted accounting principles.

*PricewaterhouseCoopers LLP*

**Chartered Accountants**



# Terrenex Acquisition Corporation

## Consolidated Balance Sheets

As at December 31, 2003 and 2002

	2003 \$	2002 \$
<b>Assets</b>		
Quoted investments (note 11)	10,866,086	897,914
Unquoted investments	271,600	5,662,564
Cash and term deposits	773,645	764,761
Accounts receivable and prepaids	245,703	222,074
Capital assets (note 4)	18,552	24,071
Oil and gas properties (note 5)	980,752	1,041,662
	<u>13,156,338</u>	<u>8,613,046</u>
<b>Liabilities</b>		
Accounts payable and accrued liabilities	<u>72,172</u>	<u>30,713</u>
<b>Shareholders' Equity</b>		
Capital stock (note 6)	10,063,563	10,264,048
Retained earnings (deficit)	<u>3,020,603</u>	<u>(1,681,715)</u>
	<u>13,084,166</u>	<u>8,582,333</u>
	<u>13,156,338</u>	<u>8,613,046</u>
<b>Commitments and contingencies (note 1 and 10)</b>		
Subsequent event (note 11)		
Net asset value per common share (note 11)		
Basic	3.45	2.26
Diluted	3.43	-

### Approved by the Board of Directors

(Signed) "Russ Hammond" \_\_\_\_\_ Director

(Signed) "Peder Paus" \_\_\_\_\_ Director



# Terrenex Acquisition Corporation

## Consolidated Statements of Operations and (Deficit) Retained Earnings For the years ended December 31, 2003 and 2002

	2003 \$	2002 \$
<b>Investment income</b>		
Net realized gain on investments	2,996,282	113,141
Change in unrealized appreciation in value of investments (note 11)	2,233,763	462,794
Unrealized exchange losses on investments	(192,825)	-
Investment write down	-	(2,202,965)
	<u>5,037,220</u>	<u>(1,627,030)</u>
<b>Oil and gas operations</b>		
Production revenue	162,155	147,061
Royalty expense	(38,073)	(23,602)
Operating expenses	(31,773)	(27,202)
Depletion	(60,910)	(305,572)
	<u>31,399</u>	<u>(209,315)</u>
<b>Other revenues and expenses</b>		
General and administration	338,564	345,127
CRA litigation costs	49,012	59,119
Interest, royalty and dividend income	(30,468)	(39,147)
Stock-based compensation	3,674	-
Amortization	5,519	5,519
	<u>366,301</u>	<u>370,618</u>
<b>Increase (decrease) in net assets from operations</b>	<u>4,702,318</u>	<u>(2,206,963)</u>
<b>(Deficit) retained earnings – Beginning of year</b>	<u>(1,681,715)</u>	<u>525,248</u>
<b>Retained earnings (deficit) – End of year</b>	<u>3,020,603</u>	<u>(1,681,715)</u>
<b>Subsequent event (note 11)</b>		



**Terrenex Acquisition Corporation**  
Consolidated Statements of Changes in Net Assets  
For the years ended December 31, 2003 and 2002

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	2003 \$	2002 \$
<b>Increase (decrease) in net assets from operations</b>	4,702,318	(2,206,963)
<b>Share transactions (note 6)</b>		
Stock-based compensation	3,674	-
Redemption of stock	(204,159)	-
<b>Change in net assets for the year</b>	4,501,833	(2,206,963)
<b>Net assets – Beginning of year</b>	8,582,333	10,789,296
<b>Net assets – End of year</b>	13,084,166	8,582,333
<b>Subsequent event (note 11)</b>		



# Terrenex Acquisition Corporation

## Consolidated Statements of Quoted Investments

As at December 31, 2003 and 2002

	2003			2002		
	Shares Number	Cost \$	Market value \$	Shares Number	Cost \$	Market value \$
<b>Securities</b>						
Questerre Energy Corporation (note 11)	9,522,421	7,932,991	10,474,663	-	-	-
Cadiz Incorporated	40,000	150,000	268,660	-	-	-
Huntington Exploration Inc.	266,500	199,055	53,300	266,500	199,055	21,310
Flowing Energy Corporation (formerly Bow Valley Forest Products Limited)	12,235	13,407	31,933	892,000	164,277	820,575
Afton Food Group	126,322	138,954	31,581	126,322	138,954	36,633
Transborder Capital	10,000	3,000	3,000	-	-	-
CanArgo Energy Corporation	3,516	4,356	2,338	3,516	4,356	281
Unilink Telecom	35,000	17,500	525	35,000	17,500	700
MarkeTVision Direct Inc. (formerly Via TV Marketing Corp.)	1,150	2,019	86	1,150	2,019	115
Arcis Corporation	-	-	-	15,000	27,600	12,300
Exmouth Capital	50,000	7,500	-	50,000	7,500	6,000
Falcon Well Services Ltd.	411,376	15,000	-	411,376	15,000	-
Smartor Products Inc.	942,667	451,919	-	942,667	451,919	-
Sylogist Inc.	-	-	-	178	423	-
		<u>8,935,701</u>	<u>10,866,086</u>		<u>1,028,603</u>	<u>897,914</u>



# Terrenex Acquisition Corporation

## Consolidated Statements of Unquoted Investments

As at December 31, 2003 and 2002

	2003 \$	2002 \$
<b>Loans</b>		
ECO Recycling Systems Ltd. – US \$1,000,000 6% debenture	1,292,400	1,592,600
Unsecured 8% subordinated convertible advance to Flowing Energy Corporation	-	500,000
Unsecured non-interest bearing CDN \$60,000 advance to Uentech International	60,000	-
Unsecured non-interest bearing 125,000 Euro advance to ECO Recycling Systems Ltd.	206,100	-
Unsecured non-interest bearing US \$380,900 advance to ECO Recycling Systems Ltd.	491,361	609,440
	<u>2,049,861</u>	<u>2,702,040</u>
<b>Securities</b>		
Questerre Energy Corporation – 6% Cumulative redeemable convertible preferred shares	-	4,500,000
Questerre Energy Corporation – Class A common	-	657,059
Petromin 7.5% debentures	5,500	5,500
200 ECO Recycling Systems Ltd. common shares	925	925
Other	-	5
	<u>6,425</u>	<u>5,163,489</u>
Opening valuation provision	(2,202,965)	-
Valuation provision for the year	-	(2,202,965)
Impact of foreign exchange on valuation provision	418,279	-
Closing valuation provision	<u>(1,784,686)</u>	<u>(2,202,965)</u>
Unquoted investments	<u>271,600</u>	<u>5,662,564</u>



# Terrenex Acquisition Corporation

## Notes to Consolidated Financial Statements

**December 31, 2003 and 2002**

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### **1 Nature of operations**

The company is in the business of making venture capital investments with a view to realizing future capital gains.

The ultimate realisation of the company's assets on a going concern basis will require a successful result to the Canada Revenue Agency's ("CRA") reassessment of \$18.92 million in taxes and accrued interest, as described in note 10. If the result is different than anticipated, the company may not recover the carrying value of its assets which would likely result in the company being unable to meet its obligations as they arise.

### **2 Change in accounting policy**

During the year, the company adopted a new accounting policy for stock-based compensation related to common share options. Pursuant to new transitional rules approved by The Canadian Institute of Chartered Accountants, the company now records stock-based compensation expense in the company's consolidated statements of operations and (deficit) retained earnings for all common share options granted to employees and non-employee directors on or after January 1, 2003, with a corresponding increase recorded as contributed surplus in the consolidated balance sheet.

This change in accounting policy has increased other revenues and expenses and contributed surplus by \$3,674 for the year ended December 31, 2003.

### **3 Accounting policies**

These financial statements are prepared in accordance with Canadian generally accepted accounting principles which require management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingencies at the date of the financial statements and reported amounts of revenues and expenses during the reporting period.

#### **a) Consolidation**

The consolidated financial statements include the accounts of the company and its wholly owned subsidiary, Cabernet Holdings Ltd.

#### **b) Investments**

Investments in companies which are traded on a recognized exchange, and are not otherwise restricted or thinly traded securities, are valued at the latest sale price reported by the principal securities exchange on which the issue is traded or, lacking any sales, at the closing bid prices.

Investments in securities which are restricted or thinly traded securities are recorded at estimated fair value. Estimated fair value is determined on the basis of the expected realizable value of the investments if they were disposed of in an orderly fashion over a reasonable period of time.



# Terrenex Acquisition Corporation

## Notes to Consolidated Financial Statements

December 31, 2003 and 2002

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### g) Oil and gas properties

The company is engaged in the exploration, exploitation, development and production of natural gas and petroleum and follows the full-cost method of accounting whereby all costs related to the acquisition, exploration and development of natural gas and petroleum properties are capitalized. Gains or losses are not recognized upon the disposition of properties unless a significant change in the depletion rate would result.

Depletion and depreciation are charged against producing properties, computed using the unit-of-production method where the ratio of current year production to proven reserves, before royalties, determines the proportion of depletable costs to be expensed. Non-producing properties are excluded from the depletion calculation. Gas reserves and production are converted to barrels of crude oil on a heat equivalent basis.

The capitalized costs less accumulated depletion and depreciation, future taxes and the future site restoration liability are limited to an amount equal to the estimated future net revenues from proved reserves based on year-end prices and costs, plus the lower of cost and estimated fair value of unproved properties, less estimated future general and administrative expenses, financing costs, income taxes and future site restoration costs.

### h) Stock options

Compensation expense is recorded in the consolidated statements of operations and (deficit) retained earnings for all common share options granted to employees and non-employee directors on or after January 1, 2003, with a corresponding increase recorded as contributed surplus in the consolidated balance sheets. Compensation expense for options granted during 2003 and thereafter is determined based on the fair value at the time of grant, the cost of which is recognized in the consolidated statements of operations and (deficit) retained earnings over the estimated vesting periods of the respective options. For common share options granted prior to January 1, 2003, compensation expense is not recognized. Consideration paid to the company on exercise of options is credited to share capital.

### i) Cash and term deposits

Cash and term deposits include cash on account and highly liquid investments with a term to maturity of three months or less at date of purchase.



# Terrenex Acquisition Corporation

## Notes to Consolidated Financial Statements

December 31, 2003 and 2002

### 4 Capital assets

	2003		2002
	Cost \$	Accumulated amortization \$	Net \$
Office furniture and equipment	55,187	36,635	18,552
			24,071

### 5 Oil and gas properties

	2003		2002
	Cost \$	Accumulated depletion \$	Net \$
Oil and gas properties	1,381,543	400,791	980,752
			1,041,662

The company has capitalized expenditures relating to obtaining licenses and permits for unproved land totalling \$881,543 (2002 – \$881,543). This amount has been excluded from the depletion base. During prior years, the company farmed out its interest to Questerre Energy Corporation, a related party, which operates these properties. In 2003, Questerre and Terrenex terminated the farmout agreement. In consideration of being released from its obligations under the farmout agreement, Questerre issued 750,000 common shares to Terrenex at a deemed price of \$1.00 per share and executed a mutual release.

In 2003, the ceiling test was performed using a year end price of \$6.82 per mcf of gas (2002 – \$5.75 per mcf). No write down was required in 2003 (2002 – \$94,664).

### 6 Capital stock

#### a) Authorized

An unlimited number of Class A voting common shares

3,916,957 Class B preferred shares

An unlimited number of first, second, third and fourth preferred shares issuable in series



# Terrenex Acquisition Corporation

## Notes to Consolidated Financial Statements

December 31, 2003 and 2002

### b) Issued

	2003		2002	
	Number of shares	Amount \$	Number of shares	Amount \$
<b>Common shares</b>				
Balance – December 31	3,789,990	9,793,320	3,789,990	9,793,320
<b>Class B Preferred shares</b>				
Balance – December 31	804,400	470,728	804,400	470,728
Redemption of Class B shares	(352,500)	(204,159)	-	-
	451,900	266,569	804,400	470,728
<b>Contributed surplus</b>	-	3,674	-	-
Total shares issued	4,241,890	10,063,563	4,594,390	10,264,048

### c) Class B Preferred shares

On March 30, 1999, the shareholders of the company approved a share capital reorganization. Under the reorganization, each common share of the company was converted to one Class A common share and one Class B preferred share. The Class A shares are identical to the current class of common shares. The Class B shares were redeemable at the option of the holder for one year at \$0.58 per share, or retractable by the company at any time at a price of \$0.58 per share together with accrued and unpaid dividends (“redemption price”). The redemption price was paid in cash for all shares redeemed in 1999.

The Alberta Business and Corporations Act requires the company meet certain financial tests in order to redeem its Class B shares. The company will not be able to redeem further Class B shares until the CRA reassessment (note 10) has been resolved in favour of the company. As of December 31, 2003, 137,100 Class B shares had been tendered for redemption but not redeemed. The balance owing is \$79,518. Of the 137,100 Class B shares balance outstanding, 35,000 shares were included as tendered for redemption, however, the holder of the shares claimed that the amount should have been 352,500 shares. The holder of the shares filed a statement of claim against the company and certain directors relating to this matter, which was settled in 2003. This settlement resulted in the redemption of 352,500 shares.

### d) Stock option plan

Under the Directors’ and Employees Stock Option Plan (“Plan”) up to a maximum of 10% of the common shares currently outstanding may be granted as options on common shares, without nominal or par value, in the capital stock of the company. The exercise price of each option shall not be less than the closing quotation on the last business day before the option is granted minus a discount not to exceed the maximum discount permitted under the regulation of the exchange which the company’s shares are traded on. The average vesting period of the outstanding options is 1/12 every three month period.



# Terrenex Acquisition Corporation

## Notes to Consolidated Financial Statements

December 31, 2003 and 2002

A summary of the company's stock option plan as of December 31, 2003 and 2002, and changes during the years then ended is presented below:

	Shares	Weighted-average exercise price \$	Shares	Weighted-average exercise price \$
Options outstanding – Beginning and end of year	195,000	1.00	195,000	1.00
Granted	183,500	0.23	-	-
Options outstanding – end of year	378,500	0.63	195,000	1.00
Options exercisable – end of year	225,583	0.90	195,000	1.00

The weighted-average contractual life of outstanding options at year end is 2.32 years (2002 – 1.43 years).

### e) Fair value of options granted

The fair values of all common share options granted are estimated as at the grant date using the Black-Scholes option pricing model. The weighted-average fair values of the options granted during the year and the weighted average assumptions used in their determination are as follows:

Risk-free interest rate	3.0%
Expected life	3 years
Expected volatility	136%
Weighted average fair value per option	\$0.10

## 7 Related party transactions

- In 2003, Terrenex paid directors' and consulting fees of \$72,000 (2002 – \$77,000) to directors and officers or companies controlled by them.
- At December 31, 2002, Terrenex had an unsecured 8% subordinated convertible advance to Flowing Energy Corporation ("Flowing"). In 2003, this advance was converted for 588,235 common shares of Flowing at a price of CDN \$0.85 per share.
- Accounts receivable includes \$1,946 (2002 – \$142,155) due from Flowing to Terrenex.



# Terrenex Acquisition Corporation

## Notes to Consolidated Financial Statements

December 31, 2003 and 2002

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- d) In 2003, Terrenex acquired a total of 7,013,566 common shares of Questerre Energy Corporation ("Questerre") through a series of transactions. 4,500,000 common shares were acquired for CDN \$4,500,000 via the conversion of 4,500,000 preferred shares held in prior years as unquoted investments. 1,509,666 common shares were acquired for US \$1,257,552 via the exercise of 1,509,666 common share purchase warrants at an exercise price of US \$0.83 per common share. 900,900 common shares were acquired for CDN \$999,999 via a flow-through placement at CDN \$1.11 per share. 103,000 common shares were purchased in the open market for CDN \$102,720.
- e) In 2003, \$30,000 (2002 – \$30,000) in rent was charged by Ruperts Crossing, an entity controlled by a director. At December 31, 2003, Terrenex has amounts receivable from Ruperts Crossing totalling \$137,343 (2002 – \$13,620).
- f) In 2003, Terrenex advanced ECO Recycling 125,000 Euros. In 2002, Terrenex advanced ECO Recycling Systems Ltd. ("ECO Recycling") U.S. \$380,900. At the time of the transactions, a director of the company was also a director of ECO Recycling. In 2002, an impairment provision of \$2.2 million was made against the carrying value of Terrenex's investment in ECO Recycling.
- g) In 2003, Terrenex advanced Uentech International CDN \$60,000. A director of the company is also a director of Uentech International.

## 8 Income taxes

The following table summarizes the tax effect of the temporary differences which give rise to the future income tax asset at December 31, 2003:

	2003 \$	2002 \$
Future income tax assets		
Oil and gas properties	2,752,669	3,275,667
Income tax losses	356,529	1,044,156
Capital assets	10,421	13,286
Other	55,139	60,146
Future income tax liabilities		
Quoted and unquoted investments	(929,283)	(229,057)
Valuation allowance	(2,245,475)	(4,164,198)
	<hr/>	<hr/>
	-	-



# Terrenex Acquisition Corporation

## Notes to Consolidated Financial Statements

December 31, 2003 and 2002

The provision for income taxes reflects an effective rate which differs from the expected income tax rate of 36.62% (2002 – 39.12%). The primary differences are as follows:

	2003 \$	2002 \$
Decrease in net assets resulting from operations	4,702,318	(2,206,963)
Expected tax at combined federal and provincial statutory rates	1,721,989	(863,364)
Non-taxable portion of capital gains	(528,726)	(29,881)
Resource allowance	(7,989)	(8,453)
Other	176,598	(55,942)
Tax benefit of accounting losses not recognized	(1,361,872)	957,640
Provision per financial statements	-	-

The company has non-capital losses of \$1,029,836 (2002 – \$2,973,110) which expire at various times to 2007 and which may be applied in the prescribed manner against future taxable income. The company has unrestricted resource deductions of \$1,655,072 (2002 – \$1,667,788) which may be carried forward indefinitely and applied in the prescribed manner against future taxable income. In addition, the company has restricted resource deductions of \$7,246,195 (2002 – \$7,246,195) which can only be used against resource profits from successored properties.

## 9 Financial instruments

- The company's financial instruments recognized in the balance sheet consist of cash and term deposits, accounts receivable, quoted and unquoted investments, accounts payable and accrued liabilities and other liabilities.
- The fair values of cash and term deposits, accounts receivable, and accounts payable and accrued liabilities approximate their carrying values due to the short term nature of the instruments.
- Quoted securities are carried at fair market value as disclosed in the Statements of Quoted Investments.
- The fair value of unquoted securities and loans cannot be practically determined with sufficient reliability. However, provision has been made for known impairment. The investments are detailed in the Statements of Unquoted Investments.



# Terrenex Acquisition Corporation

## Notes to Consolidated Financial Statements

December 31, 2003 and 2002

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### 10 Commitments and contingencies

- a) In 2000, the company received a reassessment from CRA with respect to the company's 1995 reorganization. CRA's position is that the reorganization did not have the effect of increasing the tax basis of the company's investment in the shares of JKC Oil and Gas plc. The reassessment would increase the company's federal and provincial taxes payable by \$12.46 million and \$6.46 million, respectively, including interest accrued to December 31, 2003.

The company received professional advice with regard to the 1995 re-organization and will be vigorously contesting the notice of reassessment. The CRA has denied the Notice of Objection filed by the company and a Notice of Appeal has been filed with the Tax Court of Canada. Management is of the opinion that the company will ultimately not have a liability associated with this reassessment. Nevertheless, the actual amount of liability, if any, cannot be determined at this time.

- b) The company is committed to payments under operating leases for office space as follows:

	\$
2004	15,000

### 11 Subsequent event

Subsequent to the year end, the value of the company's investment in Questerre Energy Corporation ("Questerre") has declined significantly. On February 22, 2004, Questerre announced poorer than expected test results for a natural gas well, followed by an announcement on April 1, 2004 that a Questerre subsidiary had filed for creditor protection. On April 2, 2004, Questerre's common share trading price closed at \$0.28 per share, a decline of \$0.82 from the value attributed to the investment as of December 31, 2003. At the April 2, 2004 trading price, the Questerre shares held by the company as of December 31, 2003 would have been valued at \$2,666,278, or \$7,808,385 less than value attributed to the investment in these financial statements (a \$2.06 reduction in the company's net asset value per common share).



## **Management's Discussion and Analysis For the Year Ended December 31, 2003**

The following discussion of financial condition and results of operations was prepared by Management of Terrenex Acquisition Corporation ("Terrenex" or the "Company") at May 17, 2004 and should be read in conjunction with the consolidated financial statements and notes thereto for the years ended December 31, 2003 and 2002. It offers Management's analysis of Terrenex's financial and operating results and provides estimates, where possible, of Terrenex's future financial and operating performance based on information currently available. Actual results may vary from estimates and variances may be significant.

Additional information relating to the Company is available on SEDAR at [www.sedar.com](http://www.sedar.com).

Terrenex Acquisition Corporation is an investment company that adds value through equity capital together with financial and strategic management services. The Company focuses on early stage opportunities with high potential in domestic and international markets.

While the Company does not typically control its investments, it generally acquires a meaningful position together with the ability to influence the ultimate success of an investment. The Company only invests long-term in situations where it can dedicate the time and energy required to maximize the potential for success for all stakeholders.

### **1. Overall Performance**

Terrenex reported an increase in net assets of \$4.7 million in 2003. This translates to an increase of over 50% in net asset value per Common Share to \$3.45 in 2003. The financial performance was largely a result of the gain realized on the successful disposition of its investment in Flowing Energy Corporation ("Flowing") and the appreciation in its investment in Questerre Energy Corporation ("Questerre").

Terrenex's efforts in 2003 focused on the management of its significant investments - Questerre and ECO Recycling Systems Ltd ("ERS").

#### *Questerre Energy Corporation*

Questerre Energy Corporation targets scalable high-risk high-reward natural gas projects in Canada. The Corporation has two projects - the St. Lawrence Lowlands in Quebec and the Beaver River Field in British Columbia.

Questerre represents Terrenex's largest investment. Based on the closing price of Questerre's common shares on December 31, 2003 of \$1.10, Terrenex's investment in Questerre is carried at its quoted value of \$10.5 million. Terrenex, directly and indirectly, holds 9,522,421 common shares representing 21.32% of the issued and outstanding common share capital of Questerre. Four Directors of Terrenex serve as Directors or Officers of Questerre.



On December 7, 2000, Terrenex, and its wholly owned subsidiary, Cabernet Holdings Limited ("Cabernet"), entered into a farmout agreement with Questerre (the "Terrenex Farmout Agreement"). Pursuant to the agreement, Questerre was entitled to earn an 80% interest in 19 gas exploration licenses held by Terrenex covering 380,283 hectares of land in the St. Lawrence Lowlands in Quebec by assuming operatorship of these lands, drilling and testing one well on the lands and maintaining the annual work commitments required to keep the licenses in good standing. While Questerre maintained the annual work commitments required to keep the licenses in good standing during the term of the agreement, it did not drill on the lands encompassed by the licenses. During the term of this agreement, in consideration for extensions granted by Terrenex to drill a well on the lands, Questerre issued 1,050,000 common share purchase warrants at an exercise price of US\$0.83 per common share to Terrenex. In May 2003, Questerre and Terrenex terminated the agreement. In consideration of being released from its obligations under the agreement, Questerre issued 750,000 common shares to Terrenex. In addition, Questerre and the Terrenex executed a mutual release in respect of the Terrenex Farmout Agreement. Terrenex subsequently relinquished these licenses in July 2003.

In July 2003, Questerre successfully completed its initial public offering for gross proceeds of \$7.4 million and listed on the Toronto Stock Exchange. The Corporation also completed a series of equity transactions with Terrenex for gross proceeds of \$2.7 million. This comprised of \$1.7 million by the exercise of 1,509,666 common share purchase warrants at US\$0.83 per common share and \$1 million by a private placement of 900,900 flow-through common shares at \$1.11 per common share. Questerre also completed two additional private placements during the year for gross proceeds of \$275,200. Terrenex, and its wholly owned subsidiary Cabernet Holdings Limited, also elected to convert 2,000,000 and 2,500,000 Series I preferred shares respectively into common shares of Questerre at a conversion price of \$1.00 per common share.

During the year, Questerre made significant progress with its exploration acreage in the St. Lawrence Lowlands.

In May 2003, Questerre applied for and was granted exploration licenses issued by the Ministry of Natural Resources (Quebec) covering 287,915 hectares of land in the St. Lawrence Lowlands. Questerre holds an 82% working interest and Terrenex holds a 15% working interest in this acreage. Questerre, on behalf of Terrenex and a third party, subsequently concluded an agreement with Gastem Inc., a Montreal-based junior to develop this acreage. Pursuant to this agreement, Gastem is required to pay 75% of the costs of a well to earn a 50% interest in such a well and in 1,000 hectares of land surrounding the location of the well. In addition, for a period of six months after the testing of the initial well and any additional wells Gastem will also have an exclusive rolling option to drill further wells on the lands on the same terms. The Sainte Sophie #1 well will be the first well of a proposed multi-well exploration program and is anticipated to spud June 2004 after breakup.

Utilizing the proceeds of its initial public offering, Questerre commenced the A-5 re-entry at the Beaver River Field. The objective of the A-5 re-entry was to generate sufficient cash flow to spud a new compartment well at the Beaver River Field. The target, clearly defined on a 3-D seismic survey, was 130 m of relatively low risk reservoir structure up-dip from the highest producing well in the field.



Due to operational problems, the well took substantially longer than expected and was completed in February 2004. The well did not encounter the target up-dip structure and initial test results of 3 mmcf/d and associated formation water fell short of Management's expectations. Tie-in to production facilities and the field gathering system was completed in March 2004 and the well was placed on a long-term production test shortly thereafter.

The announcement of these results precipitated a significant decline in Questerre's share price from \$1.20 to \$0.51. Consequently, based on a closing price of \$0.30 at March 31, 2004 as compared to the year-end price of \$1.10, Terrenex recorded an unrealized depreciation in the value of its investment in Questerre of \$7.6 million. As at May 2004, Questerre's common shares continue to trade in the \$0.30-\$0.32 range.

The financial impact of the unsuccessful well was compounded by the cost overruns. The A-5 re-entry, budgeted at \$6.5 million, including completion, testing and tie-in costs, is now expected to cost over \$18 million. Problems unrelated to downhole conditions account for a majority of the cost overruns. Notwithstanding, actual drilling took 41 days at an approximate cost of \$3.3 million.

In response to the cost overruns, Management of Questerre arranged for additional financing of \$5.9 million in 2003 and early 2004. Of this amount, \$2.7 million was provided by Terrenex and \$1.2 million was provided directly by Management of Questerre. Notwithstanding, trade payables of approximately \$9 million remain outstanding.

These substantial cost overruns led to serious financial difficulty for Questerre's wholly owned subsidiary, Questerre Beaver River Inc. ("QBR") that holds Questerre's interest in the Beaver River Field. On April 1, 2004, QBR applied for and was granted an Initial Order by the Court of Queen's Bench of Alberta providing for creditor protection under the Companies' Creditors Arrangement Act ("CCAA"). The filing under CCAA is intended to allow QBR to restructure its affairs while continuing operations on a normalized basis. The Court Order prohibits creditors from taking action against QBR and prevents QBR from paying most claims which arose before April 1, 2004.

QBR is currently developing a plan of arrangement between itself and its creditors and other stakeholders. The Corporation is proceeding on the basis that the creditors will accept this plan to allow for the continued development of the Beaver River Field.

#### *ECO Recycling Systems Ltd.*

ECO Recycling Systems Ltd. ("ERS") provides remedial waste management solutions for the petroleum and petrochemical industries in Europe.

Terrenex has invested approximately \$2 million in ERS through a \$1.3 million 6% debenture and \$0.7 million through unsecured advances. An impairment provision of \$1.8 million was made against the carrying value of this investment in 2003. The Chairman of Terrenex sits on the Board of ERS to monitor the Company's investment in ERS.



In 2001, ERS established a new processing facility in the south of France near the largest refinery conglomeration in the area. The commission of these facilities over the last two years proved more challenging than expected and the subsequent delays have set back ERS's business plan by up to 18 months. In early 2004, ERS reported it made substantial progress resolving these operational issues and expects the facility to be at capacity by the fourth quarter of 2004.

#### *Canada Revenue Agency Reassessment*

In 2000, Terrenex received a reassessment from the Canada Revenue Agency ("CRA") with respect to the Company's 1995 reorganization. CRA's position is that the reorganization did not have the effect of increasing the tax basis of Terrenex's investment in the shares of JKX Oil & Gas plc. The reassessment would increase the Company's federal and provincial taxes payable by \$12.46 million and \$6.46 million, respectively; including interest accrued to December 31, 2003.

Terrenex received professional advice with regard to the 1995 reorganization and will be vigorously contesting the Notice of Reassessment and has filed a Notice of Objection. The CRA has denied the Notice of Objection filed by the Company and a Notice of Appeal has been filed with the Tax Court of Canada. Management is of the opinion that the Company will ultimately not have a liability associated with this reassessment.

Should the CRA claim prove correct, the amount of income taxes payable would be in excess of the Company's current asset value and render Terrenex insolvent. Nevertheless, the actual amount of the liability, if any, cannot be determined at this time.

## **2. Select Annual Information**

A selection of financial information, derived from the Company's consolidated financial statements for the last three years ended December 31, are presented below:



## Consolidated Statements of Operations

	Year Ended December 31		
	2003	2002	2001
	\$	\$	\$
<b>Investment Income</b>			
Net realized gain on investments	2,996,282	113,141	23,954
Changed in unrealized appreciation in value of investments	2,233,763	462,794	(163,719)
Unrealized exchange gains on investments	(192,825)	-	(11,679)
Investment write down	-	(2,202,965)	-
Total Investment Income	5,037,220	(1,627,030)	(151,444)
<b>Oil &amp; Gas Operations</b>			
Production Revenue	162,155	147,061	39,349
Royalty Expense	(38,073)	(23,602)	(6,207)
Operating Expense	(31,773)	(27,202)	(8,023)
Depletion	(60,910)	(305,572)	(34,309)
	31,399	(209,315)	(9,190)
<b>Other Revenue &amp; Expenses</b>			
General and administration	338,564	345,127	418,145
CRA litigation costs	49,012	59,119	81,000
Interest, royalty and dividend income	(30,468)	(39,147)	(144,411)
Stock-based compensation	3,674	-	(168,985)
Amortization	5,519	5,519	3,824
	366,301	370,618	189,573
<b>Increase (decrease) in net assets from operations</b>	<b>4,702,318</b>	<b>(2,206,963)</b>	<b>(350,207)</b>

## Consolidated Balance Sheets

	Year Ended December 31		
	2003	2002	2001
	\$	\$	\$
Quoted Investments	10,866,086	897,914	452,821
Unquoted Investments	271,600	5,662,564	7,255,164
Cash and term deposits	773,645	764,761	1,338,912
Oil & gas properties	980,752	1,041,662	1,327,072
Total Assets	13,156,338	8,613,046	10,805,086
Total Liabilities	72,172	30,713	15,790
Shareholders' Equity	13,084,166	8,582,333	10,789,296
Net asset value per common share	3.45	2.26	2.85



### 3. Summary of Quarterly Results

A selection of financial information, derived from the Company's consolidated unaudited quarterly financial statements for each of the eight quarters ended December 31, 2003, are presented below

	First Quarter Ended March 31, 2003 \$	Second Quarter Ended June 30, 2003 \$	Third Quarter Ended September 30, 2003 \$	Fourth Quarter Ended December 31, 2003 \$
Investment Income	340,500	1,775,100	1,089,900	1,831,720
Oil & Gas Operations	23,300	27,200	15,300	(34,401)
Other Revenue & Expenses	114,300	111,300	93,700	47,001
Increase (decrease) in net assets from operations	249,500	1,691,000	1,011,500	1,750,318

  

	First Quarter Ended March 31, 2002 \$	Second Quarter Ended June 30, 2002 \$	Third Quarter Ended September 30, 2002 \$	Fourth Quarter Ended December 31, 2002 \$
Investment Income	231,900	33,000	101,000	(1,992,930)
Oil & Gas Operations	1,600	46,000	27,000	(283,915)
Other Revenue & Expenses	107,000	121,000	73,000	691,618
Increase (decrease) in net assets from operations	126,500	(42,000)	55,000	(2,346,463)

### 4. Results of Operations

#### Results of Operations – 2003 compared to 2002

##### Investment Income

Terrenex reported investment income of \$5.03 million for the year ended December 31, 2003 (2002: \$1.63 million loss). \$2.9 million of this amount is attributable to the gain realized on the sale of 1.47 million shares of Flowing at an average price of \$2.50 during the year. The remainder is attributable to the appreciation in the value of its investment in Questerre at December 31, 2003 offset by an exchange loss of \$0.2 million, due to a depreciating US dollar, on the Company's investment in ERS.



### Oil & Gas Income

Terrenex reported net oil & gas revenue of \$0.03 million in 2003 (2002: 0.2 million loss). The revenue is attributable to an 18.38% working interest in a gas well in Ponoka, Alberta. The interest in the well was acquired from Flowing effective September 30, 2001 in settlement of a \$500,000 non-interest bearing demand promissory note issued to Terrenex by Flowing. Lower average daily production during the year of 12 boepd as compared to 17 boepd in 2002 was offset by higher average prices.

### Other Revenue & Expenses

General and administrative expenses remained relatively unchanged for 2003 at \$0.34 million (2002: \$0.35 million). These expenses comprised of the following for the years ended December 31, 2003 and 2002:

	Year Ended December 31,	
	2003	2002
	\$	\$
Management Fees	72,000	77,000
Salary Expense	109,168	105,786
Accounting & Audit Fees	26,100	25,675
Rent	29,650	29,350
Transfer Agent	7,227	15,634
Business Development & Entertainment Expense	35,736	26,261
Other	58,683	\$65,421
Total	338,564	345,127

### **Results of Operations – 2002 compared to 2001**

#### Investment Income

Terrenex reported an investment loss of \$1.63 million for the year ended December 31, 2002 (2001: \$0.15 million). This loss is primarily attributable to a provision of \$2.2 million made in the carrying value of Terrenex's investment in ERS (2001: nil). It was partially offset by the realized gain on the sale of investments of \$0.11 million (2001: \$0.02 million) and the appreciation of its quoted investments by \$0.46 million (2001: depreciation of \$0.16 million). The appreciation of the Company's investment in Flowing represented the majority of the unrealized appreciation in the value of its quoted investments in 2002.

#### Oil & Gas Operations

The oil and gas revenue reported by Terrenex derives from a minority interest in a producing property acquired effective September 30, 2001. For the year ended December 31, 2002, Terrenex recorded oil and gas revenue net of royalties and operating expenses of \$0.10 million (2001 - \$0.03 million). The financial statements for the year ended December 31, 2001 only reflect production for the fourth quarter of 2001, or since the effective date of the acquisition.



Terrenex recorded depletion expense of \$0.31 million for the year ended December 31, 2002 (2001: \$0.03 million). This includes a ceiling test writedown of \$0.09 million incurred in 2002 (2001: \$0). The increase in depletion expense can be attributed to the higher percentage of reserves attributable to this property that were produced during 2002 as compared to 2001.

#### Other Revenue and Expenses

General and administrative expenses declined 17% to \$0.35 million in 2002 from \$0.42 million in 2001. The majority of the decline can be attributed to the decrease in management and consulting fees from \$0.15 million in 2002 to \$0.08 million in 2001. The lower balances of cash and equivalents held by the Company during 2002 as compared to 2001 resulted in a decrease in interest, royalty and dividend income of 72% to \$0.04 million in 2002 as compared to \$0.14 million in 2001. The Company reported no exchange gain for 2002 as compared to a gain of \$0.17 million in 2001. This can be attributed to the appreciation in the US dollar relating to Terrenex's US Dollar denominated investments, specifically the ECO Recycling Systems debenture in 2001.

### **5. Liquidity & Capital Resources**

As at December 31, 2003, the Company reported a working capital surplus of \$0.95 million excluding its portfolio of quoted investments, valued at \$10.9 million. Terrenex's current assets include cash and equivalents of \$0.77 million and accounts receivable of \$0.25 million.

Notwithstanding the outcome of the CRA Reassessment, the Company believes it has sufficient resources to meet its obligations as they come due over the next 18 months. The Company's ability to generate additional cash to fund future significant investments and its working capital commitments over the long-term will depend on its ability to realize gains on its portfolio of quoted and unquoted investments. The Company does not anticipate completing any private placements in 2004 to augment its working capital position.

As at December 31, 2003, the Company has a capital expenditure commitment to fund its proportionate share of drilling costs associated with the Sainte Sophie #1 well in the St. Lawrence Lowlands in Quebec. Based on a cost estimate of \$3 million, Terrenex's share of these costs is estimated at \$0.11 million.

### **6. Transactions with Related Parties**

On December 7, 2000, the Company and its wholly owned subsidiary, Cabernet Holdings Limited ("Cabernet"), entered into a farmout agreement with Questerre (the "Terrenex Farmout Agreement"). All the Directors of Terrenex serve as Directors or Officers of Questerre. In addition, the President of Terrenex is President and Chief Executive Officer of Questerre. Pursuant to the agreement, Questerre was entitled to earn an 80% interest in 19 gas exploration licenses held by the Company covering 380,283 hectares of land in the St. Lawrence Lowlands



in Quebec by assuming operatorship of these lands, drilling and testing one well on the lands and maintaining the annual work commitments required to keep the licenses in good standing. While Questerre maintained the annual work commitments required to keep the licenses in good standing during the term of the agreement, it did not drill on the lands encompassed by the licenses. During the term of this agreement, in consideration for extensions granted by the Company to drill a well on the lands, Questerre issued 1,050,000 common share purchase warrants at an exercise price of US\$0.83 per common share to Terrenex. In May 2003, Questerre and Terrenex terminated the agreement. In consideration of being released from its obligations under the agreement, Questerre issued 750,000 common shares to Terrenex. In addition, Questerre and Terrenex executed a mutual release in respect of the Terrenex Farmout Agreement.

In November 2003, Terrenex extended a standby equity commitment to Questerre in the amount of \$1.7 million. The commitment would be fulfilled, at Terrenex's option, through the exercise of up to 1,509,666 common shares purchase warrants ("warrants") at US\$0.83 per common share held by Cabernet or a subscription for common shares at market price. Questerre subsequently drew down the equity commitment and Cabernet exercised 1,509,666 warrants for gross proceeds of \$1.7 million. Terrenex and Cabernet also elected to convert 2,000,000 and 2,500,000 Series I preferred shares respectively into common shares of Questerre at a conversion price of \$1.00 per common share. The Company also participated in Questerre's initial public offering and purchased 100,000 common shares at \$1.00 per common share. The Company further purchased 3,000 common shares in the market at a price of \$0.91. In December 2003, Terrenex completed a \$1 million private placement with Questerre. The placement consisted of the issuance of 900,900 common shares, issued on a flow-through basis, at \$1.11 per common share. As a results of these transactions, the Company, directly and indirectly holds 9,522,421, representing 21.23% of the issued and outstanding capital of Questerre.

In December 2003, Terrenex advanced ERS 125,000 Euros. The Chairman of Terrenex is also a Director of ERS. As at December 31, 2003, the Company had advanced ERS a total of \$0.69 million through unsecured non-interest bearing advances and held a \$1.3 million 6% debenture issued by ERS.

In May 2003, the Company converted an 8% subordinated convertible promissory note issued by Flowing Energy Corporation, a junior exploration and production company listed on the TSX, into 588,235 common shares at a conversion price of \$0.85 per common share. Two directors of Terrenex were directors of Flowing as at December 31, 2003. Terrenex subsequently liquidated its investment in Flowing during 2003.

During the year ended December 31, 2003, Terrenex paid Rupert's Crossing Ltd., a company controlled by two directors of Terrenex \$30,000 in rent (2002: \$30,000). At year-end, Terrenex had amounts due from Rupert's Crossing Ltd. totaling \$137,343 (2002: \$13,620). This amount was subsequently repaid in full during the first quarter of 2004.



## **7. Changes in Accounting Policy**

During 2003, the Company adopted a new accounting policy for stock-based compensation related to common share options. Pursuant to new transitional rules approved by The Canadian Institute of Chartered Accountants, the Company now records stock-based compensation expense in the Company's consolidated statements of operations and (deficit) retained earnings for all common share options granted to employees and non-employee directors on or after January 1, 2003, with a corresponding increase recorded as contributed surplus in the consolidated balance sheet.

This change in accounting policy has increased other revenues and expenses and contributed surplus by \$3,674 for the year ended December 31, 2003.

## **8. Share Capital**

The Company is authorized to issue an unlimited number of Class A voting common shares and 3,916,957 Class B preferred shares. The Corporation is also authorized to issue an unlimited number of first, second, third and fourth preferred shares in series. As at December 31, 2003 there were 3,789,990 Common Shares and 451,900 Class B Preferred Shares issued and outstanding. The Company has 378,500 stock options outstanding at an average exercise price of \$0.63. As at December 31, 2003, 225,583 of these options were exercisable at an average exercise price of \$0.90.

